

AR60



**SOUTHWARD
RESOURCES LTD.**

**ANNUAL REPORT 1986
AUGUST 31st**



PRESIDENT'S MESSAGE

To the Shareholders:

Your company has completed its fifth year of operations as of the year end August 31, 1986. While reviewing this report consideration must be given to the devastating effects of the precipitous drop in world oil prices and the effects of a deregulated natural gas industry with tremendous over supply and restricted markets.

The debilitating effects of this anomalous situation raised havoc with the whole industry in general and caused the failure of many companies. The majority of the petroleum industry has survived but at great cost in terms of loss of employment caused by the reduction of billions of dollars of revenue.

At this time it is difficult to assess the long term effects that the decimated ranks of the petroleum industry may have on the infrastructure of the energy sector. Thousands of industry personnel are currently unemployed and the prospects for a near term correction of this situation are dim.

In the face of the negative results of these existing conditions, Southward's board of directors and officers have formulated a business plan that will mitigate the damage to the corporation. Our belief is that this plan will also allow growth so that with an increasing world oil price coupled with our most recent signing of a U.S. export gas contract, Southward can expect a substantial increase in revenue.

Part of the new corporate plan will encompass a proposal to the shareholders at the special and annual meeting to be held on the 20th day of February, 1987. Shareholders' approval will be sought to consolidate the existing share capital on a one for three basis. If approved the issued and outstanding common shares will reduce to 2,258,335 from 6,775,004. This consolidation will enhance the trading activity of the shares on the stock exchange and thus create more interest in Southward's common shares by the investment community.

Presumably the "roll back" will increase the share value by a like amount so that there should be no loss of value on individual shareholdings.

Coincident with the proposed consolidation the Company is offering \$350,000 worth of 12% interest bearing convertible debentures maturing in two years. The debentures are convertible at the rate of four shares per dollar of debenture. If the proposed share consolidation takes place, the conversion will be 15 shares per ten dollars of debenture. If all debentures were converted the total issued and outstanding shares would be 2,783,335.

The main reason for issuing the debentures is to finance a property acquisition and guarantee performance on our U.S. export gas contract.

Exploration

All of the Company's exploration in the 1986 fiscal year was conducted in the province of Saskatchewan.

Eight wells were drilled with various working interests ranging in the 15% bracket. Out of the eight, one well was sold for a recovery of investment and one well was dry and abandoned. The other six were completed and are currently producing. One further well was drilled by another company free to Southward when the Company farmed out its 45% working interest. This well was cased as a potential oil well but was not completed due to low oil prices.

No further work is planned in Saskatchewan for the coming year since the company will direct its exploration efforts in Alberta where the royalty structure is less onerous.



PRESIDENT'S MESSAGE (Cont.)

New Projects

The U.S. export gas contract mentioned previously will require the Company to produce an annual volume of gas in excess of one and one half billion cubic feet. These gas sales will impact our cash flow by doubling our current revenue. First sales are expected to begin in March 1987, and continue over the next several years. Fortunately the majority of the sales take place in the spring, summer and fall seasons when historically gas sales are lowest.

The revenue stream from these sales should provide the Company with discretionary income sufficient to budget for a more active exploration program than in the past.

Although the industry is forecasting a very poor year for most segments of the "oil patch" those exploration companies that have drilling budgets can take advantage of low drilling and equipping costs because of the very competitive atmosphere prevailing today. Land costs are also at "bargain basement" prices for those companies that have funds available.

We are expecting to be in a position by this summer to take advantage of the situation mentioned above. Therefore, the third and fourth quarters should show a much stronger financial position.

Financial

As a result of the drop in world oil prices the company's production revenue is approximately half that which was projected in the 1985 annual report. Even given this decline, however, our revenue from production is approximately two and one half times that of last year. For the first time in the company's history, we showed an operating profit before any accounting write downs.

General and administrative expenses were higher than budgeted due to additional legal and engineering consulting fees. We expect to reduce these general and administrative expenses during the coming year.

Summary

In conclusion I would like to take this opportunity to thank all the shareholders for their patience and understanding in these very difficult times. I would also like to thank our directors and staff for their support in what has been described as the most devastating times the Petroleum Industry has ever seen.

It is most encouraging to know that a Company such as Southward Resources Ltd., in the embryonic stages of development, can survive some of the worst economic times in an industry that has been rife with multiple forces working against it.

The Board of Directors and officers and staff of your Company look forward to the coming year with more optimism than the general public may have regarding the potential of the Petroleum Industry as a whole. Our optimism is based not upon "hope" for the future but rather it is formulated upon sound expectations and a prudent corporate business plan. Succeeding interim quarterly reports will prove the accuracy of our projections.

Respectfully submitted on
Behalf of the Board of Directors:

R.W. Kiser,
President.

AUDITOR'S REPORT

The Shareholders
Southward Resources Ltd.

We have examined the consolidated balance sheet of Southward Resources Ltd. as at August 31, 1986 and the consolidated statements of operations and deficit and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these financial statements present fairly the financial position of the company as at August 31, 1986 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Calgary, Alberta
January 15, 1987

St. Louis, Geib
Chartered Accountants

**SOUTHWARD RESOURCES LTD.
CONSOLIDATED BALANCE SHEET AS AT AUGUST 31, 1986**

ASSETS		1986	1985
Current			
Cash		\$ 314	\$ 39,260
Accounts receivable		49,711	206,097
Prepaid expenses		<u>—</u>	<u>2,704</u>
		50,025	248,061
Fixed (Note 2)		<u>1,027,038</u>	<u>1,123,435</u>
		<u><u>\$1,077,063</u></u>	<u><u>\$1,371,496</u></u>
LIABILITIES			
Current			
Bank indebtedness		\$ 250,000	\$ —
Accounts payable and accrued liabilities		148,665	519,457
Deferred (Note 8)		<u>—</u>	<u>20,000</u>
		398,665	539,457
Contingency and commitment (Notes 4 and 5)			
SHAREHOLDERS' EQUITY			
Share capital			
Authorized			
20,000,000 common shares without nominal or par value			
Issued (Note 9)			
6,775,004 shares (1985 - 6,600,004)		1,388,029	1,349,110
To be issued (Note 8)		—	25,000
Deficit		(759,552)	(585,576)
Cumulative translation gain		<u>49,921</u>	<u>43,505</u>
		678,398	832,039
		<u><u>\$1,077,063</u></u>	<u><u>\$1,371,496</u></u>

On behalf of the Board:
R.W. Kiser, Director
S.W. Kiser, Director

**SOUTHWARD RESOURCES LTD.
CONSOLIDATED STATEMENT OF OPERATIONS AND DEFICIT
FOR THE YEAR ENDED AUGUST 31, 1986**

	1986	1985
Revenue		
Operators fees	\$ 3,812	\$ 12,631
Production	462,883	182,605
Interest earned	4,298	2,402
	<u>470,993</u>	<u>197,638</u>
Direct expenses		
Operating	102,578	29,351
Depletion and depreciation	84,817	68,689
	<u>187,395</u>	<u>98,040</u>
Revenue from operations	283,598	99,598
Other expenses		
Exploration and non productive drilling	15,886	193,384
General and administrative (per schedule)	194,394	121,738
Interest and bank charges	21,520	318
	<u>231,800</u>	<u>315,440</u>
Operating income (loss) before undernoted item	51,798	(215,842)
Write down in carrying value of petroleum and natural gas properties (Note 2) ...	<u>225,774</u>	<u>—</u>
Loss for the year	173,976	215,842
Deficit, beginning of year	<u>585,576</u>	<u>369,734</u>
Deficit, end of year	<u>\$759,552</u>	<u>\$585,576</u>
Net loss per share	<u>\$.026</u>	<u>\$.033</u>

**SOUTHWARD RESOURCES LTD.
CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR THE YEAR ENDED AUGUST 31, 1986**

	1986	1985
Operating Activities		
Loss for the year	\$(173,976)	\$(215,842)
Charges (credits) to income not requiring cash		
Effect of exchange rate changes on working capital	6,416	20,189
Depreciation and depletion	84,817	68,689
Exploration and non productive drilling	15,886	193,384
Write down in carrying value of petroleum and natural gas properties	<u>225,774</u>	<u>—</u>
	158,917	66,420
Net change in non-cash working capital balances related to operations	<u>(211,702)</u>	<u>130,258</u>
	(52,785)	196,678
Financing activities		
Proceeds of flow through shares (Note 8)	25,000	45,000
Allocation of drilling costs to share capital	<u>(31,080)</u>	<u>—</u>
	(6,080)	45,000
Investing activities		
Acquisition of fixed assets	(369,064)	(474,025)
Allocation of drilling costs to flow through share subscribers	31,080	—
Petroleum Incentive Program Grants	49,214	111,833
Proceeds on sale of petroleum and natural gas properties	55,089	25,000
Proceeds on sale of auto	<u>3,600</u>	<u>—</u>
	(230,081)	(337,192)
Changes in cash during the year	(288,946)	(95,514)
Cash at beginning of year	<u>39,260</u>	<u>134,774</u>
Cash at end of year *	<u><u>\$ (249,686)</u></u>	<u><u>\$ 39,260</u></u>

* Cash at end of year consists of short-term bank borrowings less cash.

**SOUTHWARD RESOURCES LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
AUGUST 31, 1986**

1. ACCOUNTING POLICIES**a) Consolidation**

The consolidated financial statements include the accounts of the company and its wholly-owned subsidiary, Southward Resources Inc.

b) Oil and gas expenditures

The company follows the successful efforts method of accounting, wherein costs of exploring for and development of oil and gas reserves are capitalized. These costs include lease acquisition costs, geological and geophysical expenses and the cost of drilling productive wells. Dry holes and abandoned projects are written off when determined to be unproductive. Costs capitalized are depleted on the unit of production method based on estimated proven recoverable oil and gas reserves.

Grants receivable under Petroleum Incentives Program are accrued in the accounts at the time qualifying expenditures are made.

c) Depreciation

Furniture and fixtures are depreciated on a 20% declining balance basis and tangible oil and gas equipment is depreciated on a 30% declining balance basis.

d) Foreign currency translation

The company translates the accounts of the U.S. subsidiary to Canadian dollars by translating the balance sheet at the rate in effect at the year-end date. The statement of operations is translated at the average rate for the year. The effect of the translation is included in shareholders' equity.

2. FIXED ASSETS, at cost

	1986	1985
Petroleum and natural gas properties	\$1,244,305	\$1,261,791
Furniture and fixtures	14,070	3,864
Automotive	—	4,300
	<u>1,258,375</u>	<u>1,269,955</u>
Less accumulated depletion and depreciation	231,337	146,520
	<u>\$1,027,038</u>	<u>\$1,123,435</u>

The carrying value of the petroleum and natural gas properties was reduced during fiscal year end 1986 by \$225,774 to reflect the adjusted value of the underlying oil and gas reserves. The write down was calculated using the value of the company's proven oil and gas reserves as estimated by an independent engineering consultant using unescalated prices discounted at 10%.

3. REMUNERATION

Remuneration paid to officers and/or directors of the company amounted to \$54,000 (1985 - \$54,000) for the year.

4. BANK INDEBTEDNESS

The bank loan is payable on demand and bears interest at prime plus 1.5%. A floating charge debenture is pledged as collateral against the loan.

5. CONTINGENCY

The company is a defendant in an action arising from the fiscal 1985 drilling of certain oil and gas properties which were placed on production during the year. The plaintiff's allege to hold an interest in the respective properties. The company is not able to estimate the effect, if any, on earnings which would result from settlement in the plaintiff's favour or on the resultant carrying value of the company's investment.

6. COMMITMENT

The company has entered into a lease agreement, terminating in 1987, for office space at an annual rental of \$16,440.

SOUTHWARD RESOURCES LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)
AUGUST 31, 1986

7. SEGMENTED INFORMATION

The company conducts its petroleum and natural gas activities in Canada and the United States.

	1986		
	Canada	United States	Consolidated
Net loss	<u>\$158,465</u>	<u>\$ 15,511</u>	<u>\$ 173,976</u>
Identifiable assets	<u>\$755,764</u>	<u>\$321,299</u>	<u>\$1,077,063</u>
Capital expenditures	<u>\$359,385</u>	<u>\$ 9,680</u>	<u>\$369,064</u>
	1985		
	Canada	United States	Consolidated
Net loss	<u>\$207,169</u>	<u>\$ 8,673</u>	<u>\$ 215,842</u>
Identifiable assets	<u>\$987,518</u>	<u>\$383,978</u>	<u>\$1,371,496</u>
Capital expenditures	<u>\$474,025</u>	<u>\$ —</u>	<u>\$ 474,025</u>

8. FLOW THROUGH SHARES

The company has entered into a flow through share subscription agreement whereby 175,000 shares were issued upon completion of certain drilling expenditures. The proceeds received as consideration for this agreement were \$70,000. Because the subscriber will be receiving the deduction of certain drilling expenditures for income tax purposes, the amount credited to share capital has been adjusted for the estimated income tax benefits to be flowed out to the subscriber. The balance has been credited to specific petroleum and natural gas properties. The shares were issued from treasury on December 10, 1985.

9. STOCK OPTION

At August 31, 1986 there were stock options outstanding in respect of 675,000 common shares exercisable at \$0.15 per share. These options do not expire and were granted to directors and employees of the company.

10. INCOME TAXES

As at August 31, 1986 the company had losses for income tax purposes in the amount of \$235,102 which are available to reduce future years' income taxes. The losses and their respective years of expiry are as follows:

1989	\$116,247
1990	23,984
1991	14,363
1992	<u>80,508</u>
	<u>\$235,102</u>

CONSOLIDATED SCHEDULE OF GENERAL AND ADMINISTRATIVE EXPENSES

	1986	1985
Audit	\$ 7,000	\$ 7,000
Professional consulting	49,153	17,199
Office and general	29,326	25,552
Salaries and management fees	<u>108,915</u>	<u>71,987</u>
	<u>\$194,394</u>	<u>\$121,738</u>

**SOUTHWARD RESOURCES LTD.
ANNUAL REPORT – CORPORATE INFORMATION**

OFFICERS

Richard Wayne Kiser
President
Scott W. Kiser
Secretary Treasurer

DIRECTORS

Richard Wayne Kiser
Scott W. Kiser
Clayton G. Harmon

HEAD OFFICE

Suite 600
1010 - 1st Street S.W.
Calgary, Alberta

AUDITORS

St. Louis, Geib
Chartered Accountants
Suite 300
1010 - 1st Street S.W.
Calgary, Alberta

SOLICITORS

Bennett Jones
Barristers & Solicitors
3200 Shell Center
400 - 4th Avenue S.W.
Calgary, Alberta

TRANSFER AGENT & REGISTRAR

Guaranty Trust Company of Canada
401 - 9th Avenue S.W.
Calgary, Alberta

BANK

Canadian Imperial Bank of Commerce
Oil & Gas Group
Corporate Banking Center
700, 505 - 5th Street S.W.
Calgary, Alberta

STOCK EXCHANGE

Alberta Stock Exchange
Suite 300
300 - 5th Avenue S.W.
Calgary, Alberta

TRADING SYMBOL

SWD

